

Presentation To:

**California Debt and Investment Advisory Commission  
6<sup>th</sup> Annual Pre-Conference**

on

**Establishing Issuer Due Diligence And  
Disclosure Programs**

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- I. **ISSUER HAS PRIMARY LEGAL RESPONSIBILITY TO MAKE COMPLETE, ACCURATE AND TIMELY DISCLOSURE IN ITS OFFICIAL STATEMENTS**
  - A. **Federal Securities Law Requirements**
    - 1. § 17(a) Securities Act of 1933, Section 10(b) of Securities Act of 1934 and SEC Rule 10b-5. See *Background Materials I*
      - a. Rule 10b-5 – unlawful **“to make an untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading”**
    - 2. SEC has repeatedly emphasized the Issuer of bonds has the primary legal responsibility for the accuracy and completeness of the information in its Official Statement
      - a. SEC Orders against: San Diego (2006), City of Miami (2003), Maricopa County (1996) and Massachusetts Turnpike Authority (“MTA”) (2003). Report on Orange County (1996). See *Background Materials II and III*
      - b. Issuer cannot “outsource” to its consultants its primary legal responsibility for disclosure. See SEC Order against City of Miami (2003)

**A. Federal Securities Law Requirements (cont'd)**

- c. SEC Chairman Cox has proposed increased SEC authority over disclosure by Issuers. See *Background Materials IV*

**B. State Securities Laws and Common Law May Impose Stricter Obligations**

**C. Inadequate Disclosure Has Costly Consequences**

- a. City of San Diego – investigations costing over \$30 M
- b. Neshannock (PA) Township School District—monetary penalty even after paying IRS
- c. Holmes Harbor, a special district in State of Washington—paid settlement to investors on behalf of itself and its board members for faulty information from developer of assessment district
- d. Superstition Mountains, an Arizona sewage district—settled with investors on start-up wastewater system financing

## II. ESTABLISHMENT BY ISSUER OF PRACTICES TO ASSURE PROPER DISCLOSURE

### A. Introduction: There is No “One Size Fits All” Approach To Disclosure Practices

1. Smaller less frequent Issuers may not have resources to develop and implement comprehensive disclosure practices, like those outlined in (B) below
  - a. For these Issuers, education is the most important aspect of their disclosure policy
  - b. Each time an Issuer commences a financing may require a “refresher course” for its officials on their legal disclosure obligations
2. *However, this does not mean that different rules apply to large Issuers and to small Issuers.*
  - a. *All Issuers must comply with same disclosure obligations, including SEC Rule 10b-5*

## **B. Governing Body Adopts Disclosure Policy**

1. Re-affirming Issuer's commitment to make proper disclosure
2. Establishing clear and focused responsibility for fulfilling Issuer's disclosure responsibilities
  - a. Identify an individual or very small group ("Disclosure Coordinator") responsible for assembling, review and approval of each Preliminary Official Statement and other disclosure information
3. Empowering Diligence Coordinator with sufficient authority to assure timely and thorough cooperation by Issuer staff
4. Specific allocations of responsibilities among Issuer staff
5. Establishing method for periodic review and evaluation of diligence procedures

**C. Education and Training of Issuer Staff Concerning Legal Obligation and Market Benefits of Proper Disclosure**

**D. Diligence Procedures for Preparing Preliminary Official Statements: Essential Elements**

1. Diligence Coordinator communicates with all appropriate senior staff of Issuer:
  - a. To obtain and/or update all information relevant to proper disclosure for particular financing and preparation of Preliminary Official Statement (“POS”)
  - b. To identify any “problems” and other disclosure issues possibly relevant to specific financing
  - c. What information is material to investors? See SEC Orders against City of Miami (2003), MTA (2003) and Orange County Report (1994) in *Background Materials III*
  - d. Recommendations of other market participants. For example, National Federal of Municipal Analysts—“Recommended Best Practices In Disclosure For General Obligation and Tax-Supported Debt” (December 2001). See *Background Materials V*
2. Knowledgeable senior Issuer staff reviews draft POS to identify “big picture” disclosure issues relevant to this particular bond offering
  - a. Do not overlook the forest by focusing only on the trees

**D. Diligence Procedures for Preparing Official Statements: Essential Elements (cont'd)**

3. Consult with Issuer legal counsel re litigation and other significant matters
4. Issuer's auditors provide written consent to include their audit report in POS and final OS
  - a. In July 18, 2007 speech, SEC Chairman Cox emphasized that Issuers should obtain such written consent from their auditors
  - b. If such consent is not obtained, this must be disclosed in the POS under heading "Financial Statements"
    - i. Practical Suggestion: When Issuer negotiates engagement of its auditor, include provisions for obtaining consent for use of their audit report in POS and final OS and agree on fee for providing that consent
5. Knowledgeable senior officials of Issuer do "last read" of entire substantially final draft of POS
6. Disclosure Coordinator provides final "sign off" on POS and final OS

**D. Diligence Procedures for Preparing Official Statements: Essential Elements (cont'd)**

7. Senior Issuer officials and Diligence Coordinator do periodic review and evaluation of how the Issuer's disclosure procedures are working
  - a. To identify any "problems," "difficulties," or "oversights" under existing procedures
  - b. To identify and implement corrective actions and improve procedures
  - c. To review procedures in light of developing "best practices" for disclosure
  - d. To advise Governing Body of results of review

**E. Disclosure Procedures: Recommended Additional Elements**

1. Issuer retain Disclosure Counsel to advise Issuer on disclosure issues and give 10b-5 opinion to Issuer
  - a. If no Disclosure Counsel, obtain 10b-5 opinion from Issuer Counsel



**E. Disclosure Procedures: Recommended Additional Elements**  
(cont'd)

- b. Note: Underwriter's Counsel does not represent the Issuer. Rather, its client is the underwriter who, as the buyer of the Issuer's bonds, is "adverse" to the Issuer
- 2. Conduit due diligence meeting face-to-face among senior Issuer staff and Disclosure Counsel to review draft POS
- 3. Issuer staff required to
  - a. Prepare footnotes to draft POS showing basis in Issuer's records or other reliable sources for information in POS
  - b. Provide written confirmation to Disclosure Coordinator of accuracy and completeness of all information provided by them
- 4. Provide opportunity for Governing Body of Issuer to review and comment on substantially final draft of POS—at least 7 to 10 days prior to mailing POS
- 5. Provide confidential method for Issuer staff to advise Diligence Coordinator of any disclosure "problems"

## F. Application of Diligence Procedures To Other Issuer Statements

1. Annual continuing disclosure reports and material event notices
2. Rating Agency presentations
  - a. SEC has stated that misleading statement by an Issuer to rating agencies can violate federal security laws. See SEC Order against San Diego (2006) and MTA (2003) in *Background Materials III*
  - b. Information presented to rating agencies but not included in Official Statement
3. City websites – need to include appropriate disclaimers and date of information
4. Other statements by Issuer officials reasonably expected to reach investors

### **III. EXAMPLES OF DISCLOSURE PRACTICES**

#### **A. Use of Annual Information Statement with “Wrap-Around” Official Statement for Individual Bond Offering**

1. May be useful procedures for Issuers that sell bonds frequently each year
2. A number of frequent Issuers prepare an “Annual Information Statement” (“AIS”) describing the Issuer and its credit
  - a. Typically prepared in conjunction with the completion of its Comprehensive Annual Financial Report
3. Official Statement for a specific financing is prepared as a “supplement” to the AIS and describes the terms of the specific bonds being offered
  - a. Must analyze differences in security for various bond offerings by the Issuer
    - i. An AIS that describes credit information relevant to general obligation bonds and financings payable from general fund may not be useful for a water system financing

**A. Use of Annual Information Statements with “Wrap-Around” Official Statements (cont’d)**

- b. For each bond issue, must review AIS for any changes in information in AIS that requires “updating” in the “wrap around” supplemental OS
- 4. City of Akron, Ohio was one of the pioneers in the late 1970s in developing use of an AIS as the basis for its disclosure on its bond offerings
  - a. See excerpts of Akron 2006 AIS and OS in *Background Materials VII*

**B. State of California Treasurer’s Office**

- 1. Use of same Appendix A to describe State finances in OS for all State general obligation bonds and general fund lease financings, with update for recent events. See excerpts from recent State of California O.S. in *Background Materials VIII*

## **C. New York Issuers**

1. New York State Environmental Facilities Corporation is a state-level agency that issues bonds under several credit structures to finance loans to local governments for water and sewer projects. This agency has issued over \$7 billion of bonds, made over 900 loans and does between 5 and 10 financings each year, aggregating over \$1 billion
  - a. Uses AIS and “wrap around” Official Statement for each financing
2. State of New York and New York City Metropolitan Transportation Authority
  - a. Also use AIS in similar ways

## **D. City of San Diego Disclosure Ordinance and Procedures**

1. Basis of settlement with SEC
2. See *Background Materials VI*